creased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995-2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is illuminating. That measure varies only slightly from year to year during the 1994-1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending (spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 established for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anticrime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation; the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflation after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projections, the deficit of $284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit as a percentage of GDP). CBO's extended projections show deficits that continue to climb after 2000, reaching $421 billion (3.6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in Medicaid and Medicare, even though projected costs for those programs are somewhat lower than CBO estimated last August. All spending other than that for Medicaid and Medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected spending for the two big federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around $240 billion a year from 1999 through 2005. (The projected deficit of $242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

Changes in the Projections

The deficits that CBO currently projects for 1995 through 1999 are almost $25 billion a year higher, on average, than those projected last August (see Summary Table 4). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost $1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such legislation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost $3 billion to deficits over the 1995-1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than did legislation. Those changes have pushed down projected revenues by $9 billion in 1996 and $8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More signifi-cantly, the higher interest rates in the new forecast have driven up projected federal interest payments by more than $15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates--those changes that cannot be attributed to legislation or

Summary Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues[a]	2	9	8	3	b
Net interest	8	16	17	15	15
Other outlays	b	b	1	2	2
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues[a]	6	5	6	9	11
Deposit insurance[c]	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest[c]	b	-1	b	b	1
Other outlays	b	5	4	3	5
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

a. Revenue reductions are shown with a positive sign because they increase the deficit.

b. Less than $500 million.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

revisions in the economic forecast--have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected Medicaid spending is lower in every year--by as much as $13 billion in 1999--than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995-1999 period, but CBO's extended forecasts have significantly lower spending for Medicare as well as Medicaid in the years after 2000. The Medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than Medicare and Medicaid.

Illustrative Path to a Balanced Budget

A constitutional amendment requiring a balanced federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the state legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal. According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling $322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process is begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Summary Table 5). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effects, would produce $89 billion of the required savings of $322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security--implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

Over the entire 1996-2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than $1 trillion (in relation to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds $1.2 trillion. As noted, this path and the resulting $1.2 trillion in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996-2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period result in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will

Summary Table 5.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	0	0	0	0	-1	-2	-6	-10	-19
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes[a]	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	0	-1	-4	-10	-18	-28	-40	-54	-156
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	0	-1	-4	-10	-19	-31	-46	-64	-175
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable.

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than $500 million.

maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments--and the amount of savings from policy changes needed to balance the budget--by almost $140 billion over the 1996-2002 period.

Conclusion

CBO's most recent economic and budget projections underscore the challenge facing policymakers who may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

Chapter One

The Economic Outlook

The U.S. economy grew vigorously throughout 1994. Spurred by business investment and spending on personal consumption, real output grew at a 4 percent pace, and over 3 million new jobs were created. With inflation subdued in spite of the rapid growth, 1994 was a banner year for the economy.

If rapid growth continues, however, inflationary pressures will mount. The economy is currently at a high rate of resource use--the unemployment rate has fallen to 5.4 percent, and the nation's factories are running close to capacity. The Congressional Budget Office (CBO) estimates that once the economy attains such a high rate of resource use, sustained growth exceeding 2.4 percent would strain the economy's productive capabilities and ultimately lead to higher inflation.

Anticipating some of the current pressures on the economy's capacity, the Federal Reserve tightened monetary policy during 1994, raising short-term interest rates in an effort to slow growth. The target federal funds rate--the rate that best reflects monetary policy actions--increased by 2.5 percentage points, and long-term rates largely followed suit. Short-term interest rates are likely to rise further, and the accumulated effect of higher rates will inevitably dampen growth.

CBO forecasts that the economy will forge ahead through much of 1995 but will then slow substantially in late 1995 and early 1996. Real (inflation-adjusted) gross domestic product (GDP) is forecast to grow at a rate of 2.5 percent during 1995 but only 1.9 percent during 1996 (see Table 1-1 and Figure 1-1). The unemployment rate is expected to average 5.5 percent in 1995 and rise slightly, to 5.7 percent, in 1996.

CBO expects that strength in several sectors will encourage the Federal Reserve to tighten monetary policy further, pushing up short-term interest rates in the first half of 1995. The cumulative impact of higher interest rates--both the increases to date and the anticipated increases during the first half of this year--is likely to push the growth of GDP below 2 percent during late 1995 and early 1996.

Hence, CBO, along with most private forecasters, assumes that the Federal Reserve's monetary policy will effectively guide total spending in the economy between the shoals of inflation and recession. Because long-term interest rates are already high relative to expected inflation, further increases in short-term rates may not be echoed in long-term rates. The rate on 10-year government notes should not rise much above the 1994 year-end rate of 7.9 percent. Under CBO's forecast, inflation, as measured by the consumer price index (CPI), will increase to 3.2 percent in 1995 and to 3.4 percent in 1996.

The Federal Reserve's effort to slow growth is not without risks. It could result in a recession rather than in the relatively benign period of slow growth that CBO forecasts for late 1995 and early 1996. Such a scenario might evolve during those years if the monetary tightening to date, and the further modest tightening CBO anticipates, failed to cool the current pace of growth, and if the economy, already operating at a high level of capacity use, continued to steam ahead. Changes in fiscal policy could increase the pressure on capacity if immediate tax cuts were enacted but were not paid for by simultaneous reductions in spending. Inflation would accelerate, and economic imbalances, such as high ratios of debt to income, would probably develop. Then, when monetary policy tightened further to slow inflation, the economy could contract rapidly.

In an alternative--though rather less likely--scenario, monetary tightening may have already been sufficient to dampen economic growth in the first half of 1995. Last year's rapid growth may have been stimulated largely by transitory events, such as the one-time improvement in households' finances that stemmed from the refinancing of home mortgages during 1993. Because monetary policy has a delayed effect on the economy, the impact of the 1994 rate hikes may hit an economy that is already intrinsically weakening, in which case a period of slow growth or mild recession could occur during the first half of 1995.

Table 1-1.
The CBO Forecast for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast 1995	Forecast 1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP	5.0	6.3	5.3	4.7
Real GDP[a]	3.1	3.7	2.5	1.9
Implicit GDP Deflator	1.8	2.5	2.8	2.8
Consumer Price Index[b]	2.7	2.8	3.2	3.4
Calendar Year Averages (Percent)				
Real GDP Growth[a]	3.1	4.0	3.1	1.8
Civilian Unemployment Rate	6.8[c]	6.1	5.5	5.7
Three-Month Treasury Bill Rate	3.0	4.2	6.2	5.7
Ten-Year Treasury Note Rate	5.9	7.1	7.7	7.0

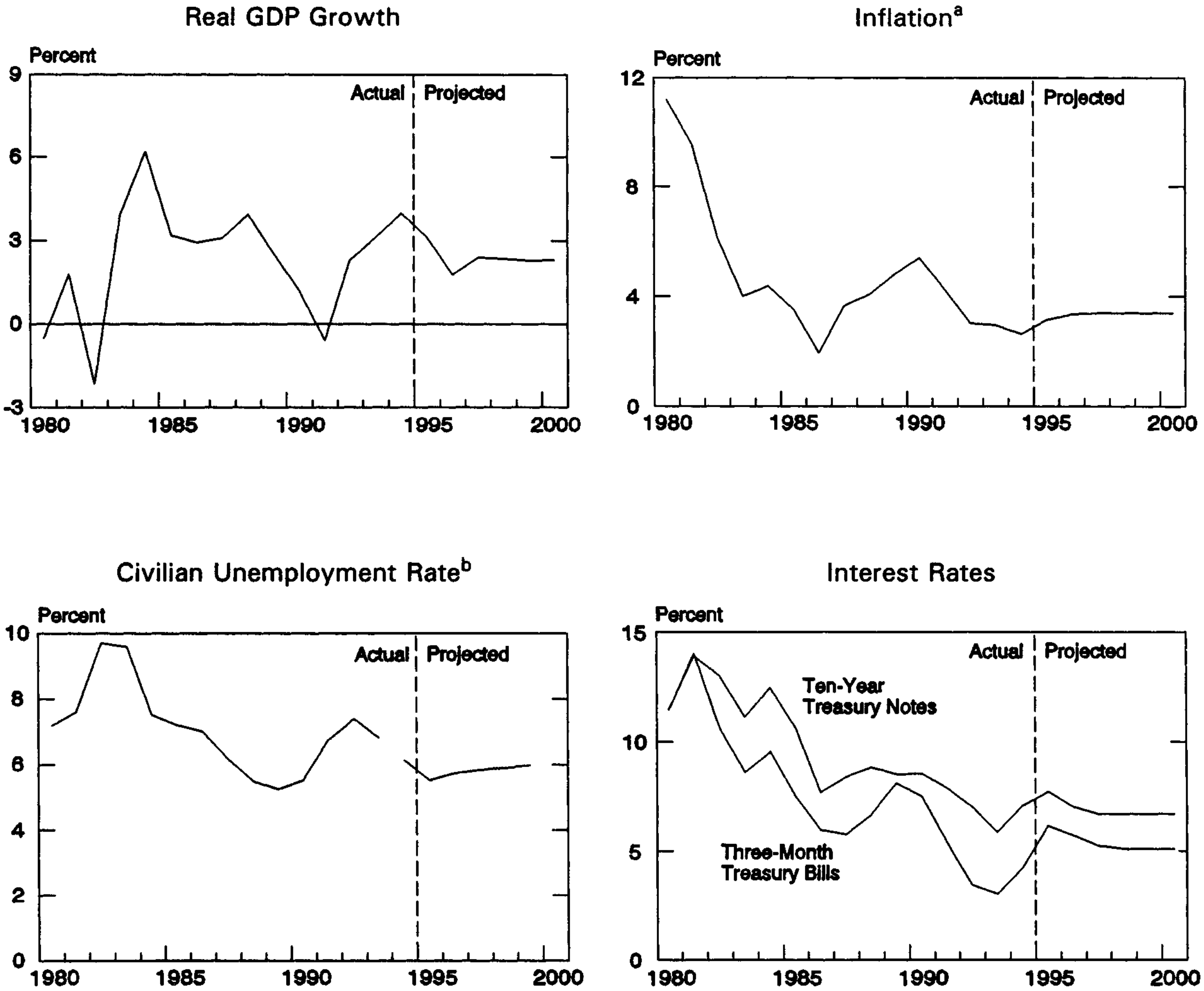
SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. The Bureau of Labor Statistics changed the unemployment survey in January 1994. Data for 1993 use pre-1994 methodology.

Figure 1-1.
The Economic Forecast and Projections



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: All data are on an annual basis; growth rates are year over year. For 1997 and subsequent years, the projections do not reflect cyclical patterns.

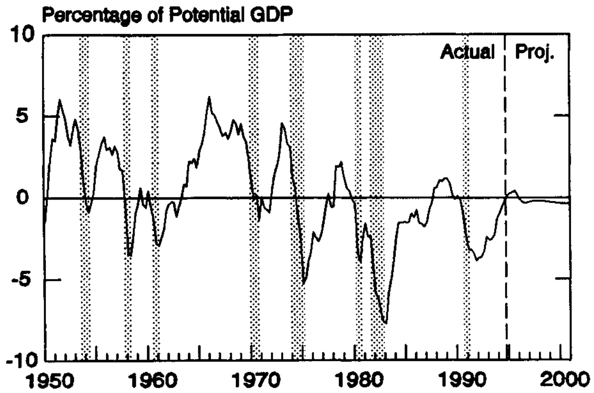
a. Consumer price index for all urban consumers (CPI-U). The treatment of home ownership in the official CPI-U changed in 1983. The inflation series in the figure uses a consistent definition throughout.

b. From 1994 on, the unemployment rate reported by the Bureau of Labor Statistics is not comparable with prior data. The discontinuity reflects an extensive revision of the survey methodology. The CBO forecast is based on the new methods.

The State of the Economy

The economy is operating at a high rate of capacity use and is still growing rapidly. If that situation continues, the economy could overheat and inflationary pressures could begin to mount. Just how serious a threat that is remains debatable, because measures of the constraints on the economy's capacity are far from precise and the data are open to conflicting interpretations. For example, gains in business investment and productivity would raise the economy's capacity, whereas increased regulation would tend to lower it. Economists look to several measures to assess the situation.

Figure 1-2.
The GDP Gap: GDP Versus Potential GDP



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: The GDP gap is GDP minus potential GDP expressed as a percentage of potential GDP. Historically, expansions typically overshoot the mark so that GDP eventually exceeds potential GDP. The actions of the Federal Reserve Board influence that outcome.

Potential GDP is an estimate of the level of output that would obtain if the economy's resources were employed to the fullest extent possible without igniting inflation. If total spending in the economy runs above potential supply for an extended period, the excess demand bids up wages and prices in competition for scarce resources. The economy is now operating slightly above its potential (see Figure 1-2).

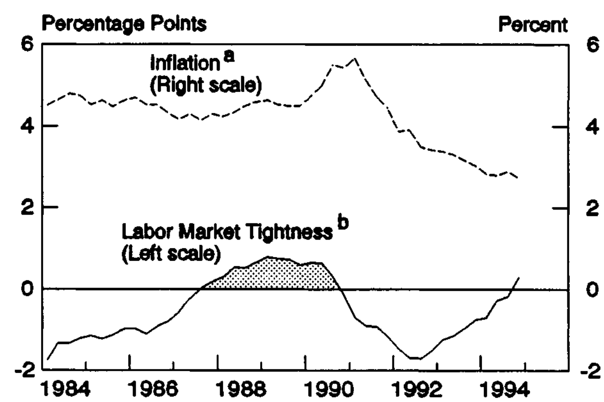
The unemployment rate also points to inflationary pressure. The current rate of 5.4 percent is below most estimates of the rate at which inflation might begin to develop (the nonaccelerating inflation rate of unemployment, or NAIRU). This tightness in the labor market indicates a future increase in wage inflation, which would in turn affect the CPI (see Figure 1-3). CBO uses an estimate of 6 percent for the NAIRU: the derivation of that estimate was explained in the summer update to CBO's 1994 outlook.

The Federal Reserve's index of capacity utilization reflects tightness only in the industrial sector of the economy, in contrast to the two broader measures mentioned above. Capacity utilization for all industries combined stood at 82.7 percent at the beginning of 1994, and the latest reported figure was 85.4 percent. An often-used rule of thumb is that inflationary pressures build when that index is above 84 percent.

Even as the constraints on capacity tighten, however, the economy remains strong. Growth of real GDP in the second half of 1994 was close to 4 percent--well above the 2.4 percent rate at which demand would grow in line with the economy's productive potential. The growth in employment and the rapid gains in industrial output also suggest continuing momentum.

Although the strength of the economy in 1994 was not entirely foreseen, the Federal Reserve tightened monetary policy last year in an effort first to end monetary stimulus and then to head off nascent inflationary pressures. It raised the target federal funds rate six times during the year, by a total of 2.5 percentage points. (The federal funds rate is the overnight rate at which depository institutions borrow from and lend to each other their monetary reserves--cash and deposits with the Federal Reserve that banks and thrifts must hold.) In doing so, the Federal Reserve steadily reduced reserves.

Figure 1-3.
Inflation and Tightening in the Labor Market



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis.

NOTE: Shading indicates a period of inflationary conditions in the labor market.

a. Consumer price index for all urban consumers (CPI-U), excluding food, energy, and used cars.

b. Tightness in the labor market is measured by the excess of CBO's estimate of the nonaccelerating inflation rate of unemployment (NAIRU) over the actual unemployment rate. It is an indicator of future wage inflation.

Both short- and long-term interest rates rose during 1994, and late in the year the spread between them began to narrow. The rate on three-month Treasury bills moved up with the federal funds rate, sometimes rising faster in anticipation of the next increase. Yields on long-term government bonds rose in response to the health of the economy in the United States, signs of stronger activity abroad, and the specter of higher inflation. Long-term rates have risen less than short-term rates, however, suggesting that the markets believe that the tightening by the Federal Reserve will eventually succeed in restraining inflation.

The initial increase in interest rates in 1994 may not have had much effect on the economy, but the increases during the second half were significant. The Federal Reserve's initial moves shifted monetary policy toward a neutral stance, allowing interest rates to "snug up" as the economy strengthened. By the middle of the year, however, the Federal Reserve was seeking to tighten sufficiently to squelch the risk of inflation. The economy repeatedly proved stronger than expected as 1994 unfolded, and that led to a succession of rate hikes as monetary policy was tightened further.

Because of the lags with which monetary actions affect the economy, the full effects of the tightening during 1994 have probably not yet occurred. The delay is typically between nine and 18 months, so the monetary tightening in 1994 should begin to affect the economy during the first half of 1995.

CBO's Forecast for 1995 and 1996

CBO expects the pace of economic activity to slow over the next two years. This economic forecast is shaped by the interaction of two striking features of the current situation: the economy's strong momentum, and the Federal Reserve's determination to resist a surge in inflation. As a result, monetary policy is expected to become progressively tighter during much of 1995 until the economy cools down.

Fiscal policy, by contrast, should neither slow nor boost the economy. CBO bases its forecast for the economy on the fiscal policy implied by CBO's baseline budget projections, and hence the forecast does not incorporate possible changes in fiscal policy or budgetary practices that the newly elected 104th Congress may enact.

Federal Fiscal Policy Is Now Neutral

Federal fiscal policy reflects the tax policies and spending decisions made by the Congress and the Administration. CBO estimates that under current tax and spending policies, federal fiscal policy will have a neutral effect on economic growth in 1995 and 1996. Because fiscal policy is not holding back the economy as it did last year, it is no longer helping to slow inflation by reducing the growth of total spending in the economy. At the same time, however, the current stance of fiscal neutrality should not conflict with restraining inflation--the current goal of monetary policy.

CBO measures fiscal policy by changes in the standardized-employment deficit, which removes from the budget the effects of the business cycle on revenues and outlays. It also removes deposit insurance outlays because they primarily reflect an exchange of existing assets that has little effect on output and employment. Based on the new economic and budget projections presented in this report, CBO estimates that the standardized-employment deficit will show little change relative to potential GDP over the next two years or, indeed, through 2000 (see Table 1-2). By contrast, in fiscal year 1994 it fell to 2.8 percent of potential GDP from 3.4 percent in 1993, implying a significant amount of fiscal restraint.

The path of the standardized-employment deficit from fiscal years 1998 through 2000 depends on assumptions about discretionary spending. The standardized-employment deficit will rise to 3.0 percent of potential GDP by fiscal year 2000 if discretionary spending is assumed to rise with inflation after 1998, but will fall to 2.6 percent of GDP if discretionary spending is assumed to remain frozen at the level of the 1998 caps.

The projected pattern of the total federal deficit differs from that of the standardized-employment deficit in that it includes the effects of the business cycle. CBO estimates that under current budget policies, the total federal deficit will decline from $203 billion in fiscal year 1994 to $176 billion in 1995, then rebound to $207 billion in 1996. Thereafter, the projected deficit will climb to $284 billion in fiscal year 2000 if discretionary spending is assumed to rise with inflation after 1998, or to $243 billion if discretionary spending is held constant in dollar terms.

Table 1-2.
The Fiscal Policy Outlook (By fiscal year, on a budget basis)

	Actual 1994	1995	1996	1997	1998	1999	2000
			In Billions of Dollars				
			With Discretionary Inflation After 1998				
Total Budget Deficit	203	176	207	224	222	253	284
Standardized-employment deficit[a]	187	200	216	223	221	247	273
Cyclical deficit	23	-8[b]	c	5	6	10	13
			Without Discretionary Inflation After 1998				
Total Budget Deficit	203	176	207	224	222	234	243
Standardized-employment deficit[a]	187	200	216	223	221	228	233
Cyclical deficit	23	-8[b]	c	5	6	10	13
Memorandum:							
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
			As a Percentage of Potential GDP				
			With Discretionary Inflation After 1998				
Total Budget Deficit	3.0	2.5	2.8	2.9	2.7	2.9	3.1
Standardized-employment deficit[a]	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Cyclical deficit	0.4	-0.1[b]	0	0.1	0.1	0.1	0.1
			Without Discretionary Inflation After 1998				
Total Budget Deficit	3.0	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-employment deficit[a]	2.8	2.8	2.9	2.9	2.7	2.6	2.6
Cyclical deficit	0.4	-0.1[b]	0	0.1	0.1	0.1	0.1

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and deposit insurance.

b. Surplus.

c. Less than $500 million.

The new Congress could, of course, point fiscal policy in other directions. It is considering some proposals, such as tax cuts, that would increase the deficit and stimulate the economy in the short term. The current budget process, however, places significant obstacles in the way of proposals that would raise the deficit. Other proposals, for cutting spending and balancing the budget, could reduce the deficit but restrain the economy in the short term. Balancing the budget would require difficult policy choices, would imply an exceptionally sustained path of fiscal restraint, and could complicate the future management of the economy in a recession. The short-term economic effects of the restraint could, however, be largely offset by the Federal Reserve, and bringing down the deficit would raise national saving and create substantial long-term benefits for the country (see Box 1-1). The fiscal policy choices of the new Congress could also affect future national income by altering the incentives for private saving, investment, and labor supply.

Strong Momentum Carries the Economy Well Into 1995

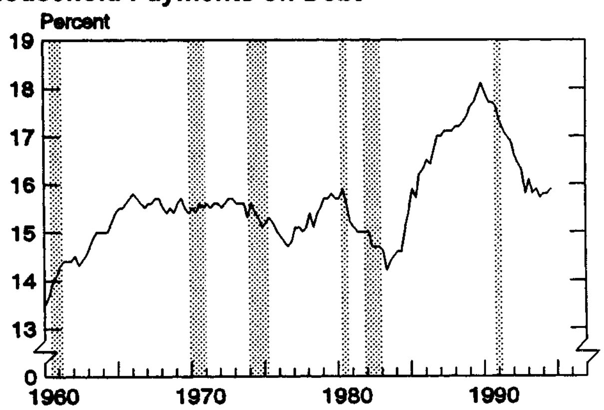
Although some sectors of the economy are slowing, major components of demand have enough momentum to carry through most of 1995. In particular, two components--personal consumption and business fixed investment--are likely to maintain a rapid pace through the first half of 1995. Net exports should also contribute to growth.

Consumer Spending Will Drive Growth During 1995. Strong growth in employment and personal income during the second half of 1994 and the reasonably solid situation of household finances will buoy consumption early in 1995. Employment and hours worked rose steadily in 1994, and households' real disposable income climbed 4.2 percent. Such growth made it possible for real spending on personal consumption to increase 3.5 percent over the year, even as the personal saving rate increased. The immediate prospect is for continued solid gains in employment and disposable income.

Even though installment debt and short-term interest rates increased last year, household finances are unlikely to dampen spending much in the first half of 1995. At the beginning of 1994, many households benefited from the substantial reduction in interest payments that was achieved by the refinancing of mortgages. Subsequently, consumer installment credit grew rapidly--about 15 percent in 1994 compared with 9 percent in 1993. Overall debt service, however, including the interest on mortgages and home-equity credit lines as well as installment debt, has not risen markedly; its share of disposable income has not changed much in the past two years, indicating that consumers have been prudent in taking on new debt (see Figure 1-4).

Spending on durable goods, such as furniture, appliances, and automobiles, has been strong for almost three years. Despite all that spending, some pent-up demand probably remains, particularly for motor vehicles, which have typically accounted for about 6 percent of consumer spending during expansions. Nominal expenditures on motor vehicles, for example, expressed as a share of disposable income, remain below the peak levels of previous cycles (see

Figure 1-4.
Household Payments on Debt



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: Payments on debt are shown as a percentage of disposable personal income. The latest data are for the third quarter of 1994.

Box 1-1.
Fiscal Policy and the Goal of a Balanced Budget

The 104th Congress is considering a constitutional amendment calling for a balanced federal budget. If the Congress adopts such an amendment, it would have to be ratified by the legislatures of at least three-fourths of the states within seven years before it would become part of the Constitution. While the states are considering the amendment, the Congress might consider it prudent to reduce the federal deficit steadily in anticipation of final ratification.

With or without a constitutional amendment, achieving and maintaining a balanced federal budget will have beneficial effects on the economy in the very long run. And gradually eliminating the deficit over several years will help to realize those benefits without the short-term economic disruptions that could result from eliminating a large federal deficit too quickly. But both the transition to a balanced budget and its maintenance over time would entail the risk of magnifying cyclical fluctuations in output and employment.

Economic Effects in the Very Long Run

Reducing the federal deficit would generate long-term benefits in the form of higher productivity, improved living standards, and less debt owed to foreigners. All of that would result from increased national saving. Deficit reductions would help to lower the cost of capital, which would increase the capital stock. With more capital to use, workers would be more productive and able to earn more income. A higher rate of national saving would also enable the United States to reduce its net indebtedness to foreigners, and future domestic investment would become less dependent on foreign sources of funding.

Some analysts also focus on the ratio of federal debt to gross domestic product (GDP) because its long-term implications are similar to those of federal deficits. A sustained fall in that ratio makes more room in investors' portfolios for productive capital assets. Based on CBO's current projections, balancing the federal budget by 2002 in the manner described on pages xix to xxi would reduce the federal debt to 44 percent of GDP in that year, compared with 56 percent under current budget policies.

Economic Effects During the Transition to a Balanced Budget

Based on the illustrative path of deficit reductions (see page xx), balancing the federal budget by 2002 would involve an average fiscal restraint of roughly 0.4 percent of GDP per year, including savings from slower growth of interest payments on the federal debt. By historical standards, the average amount of restraint per year would be less than the average amount of 0.7 percent observed during the past four decades for those years in which fiscal policy was restrictive. Nevertheless, that is a very large amount of sustained fiscal restraint; fiscal restraint generally has been imposed only for one or two years, not steadily over a seven-year period.

For several reasons, however, the net result of the fiscal restraint from balancing the federal budget is likely to be only a small detraction from short-term growth in output and employment. First, expectations of a steady reduction in credit demands by the federal government would reduce interest rates and exchange rates, which would help to boost private domestic investment and exports to U.S. trading partners.

Second, as the deficit reductions unfolded, the Federal Reserve would attempt to offset their short-run contractionary effects. Deficit reductions would reduce inflationary pressures, permitting an easier monetary policy.

Finally, the automatic response of the budget to a slowdown in economic activity would also help to stabilize economic growth during the transition to a balanced federal budget. A decline in economic activity automatically causes the deficit to increase, and that, in turn, would partially offset the initial decline. By the same token, however, weaker economic activity would make it harder to achieve a balanced budget by 2002.

Economic Effects of Maintaining a Balanced Budget

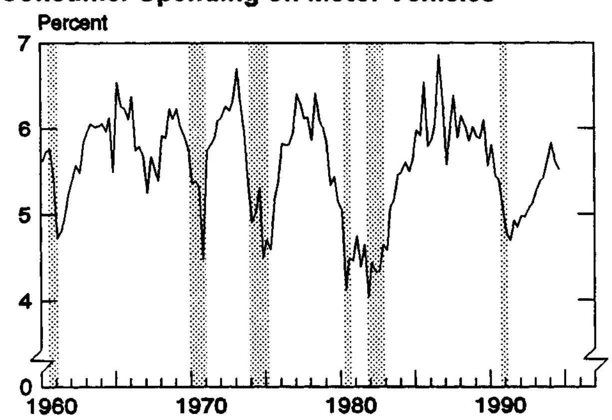
After 2002, efforts to maintain a balanced federal budget with a budget structure that is sensitive to cyclical factors could magnify downturns in output and employment unless the Congress made provisions for temporary deficits caused by recessions. Without such provisions, strict adherence to a balanced budget would mean that deficits stemming from economic slowdowns would have to be offset by cuts in discretionary outlays or by temporary tax increases. Such actions could worsen the economic slowdown unless their effects were offset by the Federal Reserve. If those offsets did not occur, the further deterioration in economic activity would increase the cyclical component of the deficit, which in turn would have to be offset by yet additional actions to lower outlays or raise revenues.

Figure 1-5). The average age of cars on the road is at a postwar high despite the large volume of new car sales in recent years, implying that households may still have a large stock of aging vehicles they would like to replace.

Judging the degree of pent-up demand is difficult, however, and several reasons for caution exist. The increased durability of cars and the shift toward pickup trucks, which last longer and are easier to repair, imply that consumers may be satisfied with slightly older vehicles. In addition, both the number of households and the number of vehicles per household are growing more slowly now than during the past two decades, and that will dampen demand for motor vehicles.

Business Investment Remains at High Levels. Business investment in both equipment and structures is expected to continue at a relatively fast clip for most of 1995. Business investment in equipment has been a driving force over the past two years, substantially outpacing growth in GDP. Real expenditures on equipment advanced at an average rate of 18 percent in 1993 and 1994. Expenditures on computers have been growing explosively, but investment in other equipment still increased at an average rate of about 12 percent over the same period. Overall investment may not continue at its recent double-digit rates, but it is still likely to be robust through much of 1995.

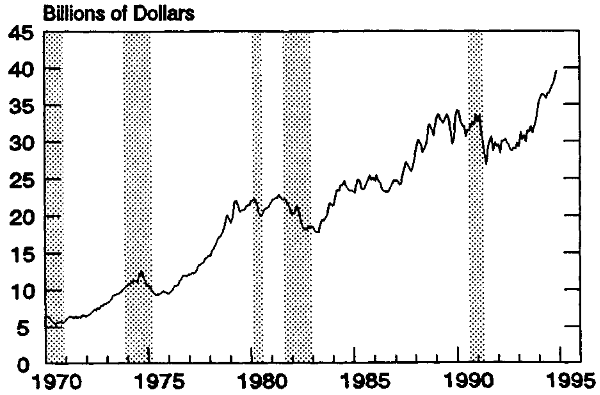
Figure 1-5.
Consumer Spending on Motor Vehicles



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Total expenditures for buying, renting, and leasing motor vehicles are shown as a percentage of disposable personal income.

Figure 1-6.
New Orders for Producers' Durable Equipment



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of the Census.

NOTE: The figure shows a three-month moving average of new orders for nondefense capital goods.

Prospects for business investment in the near term are strong given the volume of new orders for producers' durable equipment (nondefense capital goods such as machine tools and office equipment), which have yet to show signs of a slowdown. Orders eased during the first half of 1994 but snapped back after midyear (see Figure 1-6).

In contrast to spending on equipment, spending on nonresidential structures has only recently turned upward. Last year the sector began to recover, responding to a fall in the high vacancy rates left over from massive investment in office buildings, retail space, and hotels during most of the 1980s. Real business construction is likely to grow about 5 percent in 1995.

The increase in long-term interest rates in 1994 will sap some of business investment's strength during 1995. The rise in rates both increases the cost of capital to firms and creates expectations of slower growth in demand. Corporate profit margins remain healthy, however, providing firms with the means to finance much of their investment from internal cash flow. In addition, nonfinancial corporations have strengthened their balance sheets in recent years by converting short-term debt to long-term debt, making them less vulnerable to interest rate hikes.

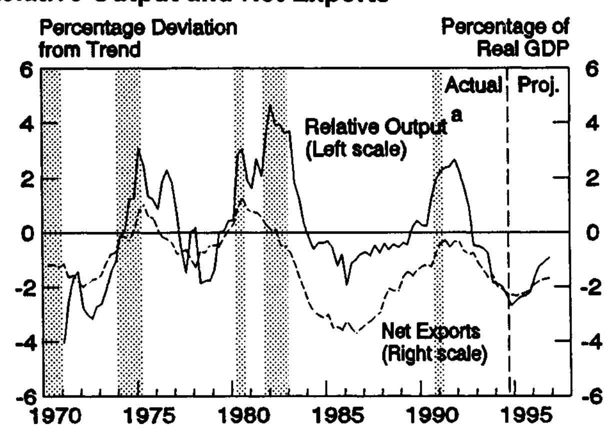
States' Fiscal Actions May Provide a Mild Stimulus. The strong economic growth of the past year and a half has given state governments an opportunity to cut taxes, even though their budgets remain tight. Revenues during 1994 were stronger than projected, and the fiscal condition of the states is much improved over that of the 1990-1993 period. Tax policies that states have enacted with their fiscal year 1995 budgets are likely to reduce revenues by about $3 billion from what they would have been. States' actions have not lowered total state revenues since 1986, in marked contrast to the numerous tax increases states passed between 1990 and 1993.

Total nominal spending by states, including spending from both their general funds and capital accounts (largely construction), is projected to grow at a slightly slower pace during 1995 than last year. States' general fund spending is projected to increase about 5 percent, with Medicaid spending continuing to capture a larger share of the growth in state budgets. Spending for employee compensation is also expected to increase about 5 percent. Pay raises account for most of that growth because state employment will inch up only 1 percent this year. Within the capital accounts, the strong growth of construction spending on highways and bridges, which has been bolstered by federal grants over the past few years, will weaken. Other capital spending, for schools and other structures, is expected to pick up.

Net Exports Will Gradually Improve. CBO forecasts that real net exports will reach a low point in the first half of 1995 before rebounding in 1996, when they are expected to contribute some $20 billion to the growth in demand for U.S. output. The improvement in net exports next year reflects the strengthening of world demand relative to demand in the United States (see Figure 1-7). Trade-weighted growth in foreign economies, which ran at 3.3 percent in 1994, will be more robust in 1995 and 1996 and is likely to surpass that of the United States. (A trade-weighted measure weights the statistics for each foreign country by its share of trade with the United States.) As foreign economies continue to strengthen, they will import more goods from the United States. Meanwhile, as U.S. growth slows in late 1995 and early 1996, so will U.S. imports of foreign goods. The turnaround in net exports will be aided by the delayed impact of the unexpected weakening of the trade-weighted dollar that occurred in 1994.

Many of the world's economies are now expanding. The pace of growth in the European economies increased more than expected last year. The economies of Germany and France grew moderately during 1994, but in both countries demand picked up noticeably in the second half, presaging growth of around 3 percent in 1995. How far output can expand and the high levels of unemployment can decline before the European economies reach inflationary levels of capacity remains to be seen. Japan's economy has barely moved out of its recession, and it continues to battle not only a strong yen but also the headwinds of the deflation of asset prices left over from the "bubble economy," when asset prices soared as a result of easy money, financial liberalization, and rapid economic growth. Yet the Japanese government has passed fiscal reforms that include a significant boost, and the economy is expected to grow at a faster clip. Elsewhere, growth remains very strong among Asia's newly industrialized countries.

Figure 1-7.
Relative Output and Net Exports



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

a. Relative output is the ratio of the rest of the world's real GDP, measured by a 28-country trade-weighted index, to real U.S. GDP. Data on relative output have been adjusted to reflect the propensity of foreign countries to import less from the United States than the United States imports from them.